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As I See

THE CAPITAL GAINS TAX AND REAL ESTATE

IN President Kennedy's message to Congress he suggested a change in the method of taxing gains on the sales of depreciable business property. He pointed out in his message that

> . . . While the taxpayer holds the property, depreciation is taken as a deduction from ordinary income. Upon its resale, where the amount of depreciation allowable exceeds the decline in the actual value of the asset so that a gain occurs, this gain under present law is taxed at the preferential capital gains rate. The advantages resulting from this practice have been increased by the liberalization of depreciation rates.
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> Our capital gains concept should not encompass this kind of income. This inequity should be eliminated, and especially so in view of the proposed investment credit. We should not encourage through tax incentives the further acquisition of such property as long as this loophole remains.
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> I therefore recommend that capital gains treatment be withdrawn from gains on the disposition of depreciable property, both personal and real property, to the extent that depreciation has been deducted for such property by the seller in previous years, permitting only the excess of the sales price over the original cost to be treated as a capital gain. The remainder should be treated as ordinary income. This reform should immediately become effective as to all sales taking place after the date of enactment. It is estimated to raise revenue by $200 million annually.

There can be no question of the fact that the depreciation allowance on real estate has been abused, and that many people have bought properties primarily for the depreciation credit they could get. The article "The Coming Bust in the Real Estate Boom," by Daniel M. Friedenberg, appearing in the June issue of Harper's, is well written, and certainly exposes some of the sharp practices which have been followed, particularly in investment properties in the larger cities.

There is much to be said, however, on the opposite side. Any treatment of capital gains is apt to be decidedly unfair in an inflationary market. Let me give an example. Suppose that in 1939 a corporation purchased a piece of business property for $1,000,000, consisting of land valued at $200,000 and a building valued at $800,000. Suppose the same piece of property is sold today for $1,395,000. The present capital gains tax on this sale would be figured as follows: Twenty-two years of depreciation on the building at 2 percent a year,

amounts to 44 percent. Forty-four percent of $800,000 amounts to $352,000. Subtracting this from the $800,000 building value leaves $448,000. Adding the value of the ground, which is not depreciated, gives us a total depreciated cost basis of $648,000. Subtracting this from the sales price of $1,395,000, leaves a capital gain of $747,000. Taxed at a maximum of 25 percent, this would result in a capital gains tax of $186,750. On the new basis which the President suggests, the tax on the same transaction would be figured as follows: The increase in price from $1,000,000 in 1939 to $1,395,000 in 1961 would be figured at the capital gains rate, 25 percent, or $98,750. The amount of depreciation taken over the 22-year period, which amounted to $352,000, would be figured at the regular corporation rate of 52 percent, or $183,040. The total tax would, therefore, amount to $281,790, or $95,040 more than the amount which would be paid on the present basis. The tax would equal 37.7 percent of the net capital gain in place of the maximum 25 percent now due under existing laws.

Gerald M. Loeb once wrote, "The real objective of investment is fundamentally to store excess current purchasing power for future use."* If this definition is accepted, the fallacy of any type of capital gains tax is readily apparent in any period when Federal fiscal policies have resulted in inflation. This is shown rather clearly by looking again at the example we have used of the building purchased in 1939.

The $1 million used to purchase the land and building in 1939 has declined in purchasing power according to the Government indexes until today it will purchase only $470,000 worth of goods and services. If the building actually sells on today's market for $1,395,000, there should be no capital gain, as the increase in the number of dollars in the sales price is only sufficient to offset the loss in the purchasing power of money. If we disregard depreciation, in order to get back the same purchasing power the corporation paid for the building in 1939, it should sell for $2,150,000, or slightly more than twice the amount it was purchased for 22 years ago.

The two scales opposite illustrate the fallacy of the Government's contention that in an inflationary market an increase in price represents a capital gain. On the 1939 scale, the building is balanced by five weights representing the dollar value of the building at that time. The 1961 scale shows the same building balanced with ten weights representing dollars at the present time. The fact that each of these symbols representing dollars is only half the size of the symbols in 1939 has no significance to the Internal Revenue Service. These symbols were called dollars in 1939 and they are called dollars in 1961, but regardless of the name, we are not talking about the same type of measurement.

*Gerald M. Loeb, The Battle for Investment Survival (New York: Simon & Schuster, 1957), p. 9.

In my opinion, any type of tax on capital gains has a scientific basis only in periods when the price level is stable or declining. There is no justification for taxing an increase in price which is due only to the fact that Government policies have reduced the purchasing power of money.

I have the same objection to the progressive income tax in an inflationary period. If today's progressive tax rates had been in force in the period from 1939 to the present, a person whose taxable income had remained constant in purchasing power would today pay a larger percentage of his income in taxes than he would have paid at any time in the past. As an example, a man with a taxable income today of $20,000 would pay 36 percent of his income in taxes. In 1939, the number of dollars of income which would have given him a purchasing power before taxes equivalent to $20,000 today would have been $9,400. Applying today's progressive income tax rates, $9,400 would have resulted in a tax of 26 percent. In other words, the progressive rate of taxes in an inflationary period has resulted in a tax rate approximately 40 percent greater today, even though we assume that today's tax rates had been in force 22 years ago.

With the continuing inflationary outlook, the great probability is that most taxpayers, due to the progressive nature of the tax, will pay a larger percentage in the future than they have in the past, even though they make no real gain in purchasing power.

In this illustration we have assumed that today's tax rates were in force in 1939. Of course, they were not. Tax rates then were much lower than they are today, and the taxpayer then with a taxable income equivalent to $20,000 today (or $9,400) paid only 10 percent of his taxable income for Federal income taxes.

1939

1961

Probably the best example of what inflationary practices can mean to the average investor is represented by the actual experience during the past 20 years on "E" bonds. A full-page advertisement appeared recently in one of the national magazines suggesting that by purchasing "E" bonds, parents could purchase four years of college education for three, as in 10 years the dollar value of the "E" bond would be one-third greater than the amount paid for the bond. If we test the truth of this advertising by the past, we arrive at totally different conclusions. A person buying "E" bonds in 1941 and cashing them out with accrued interest could at no time from 1941 to the present receive as much purchasing power as he put into them originally. In fact, if he had held these "E" bonds from 1941 to 1951 and cashed them out with his accrued interest, he would have received only 75 percent of the purchasing power he put into the "E" bonds originally, on which basis he would have paid four years tuition for three. This assumes, however, that the accrued interest was not taxable, and such was not the case. After he paid his income tax on the accrued interest, the loss in purchasing power would have been 30 percent had he been in the lowest income tax bracket, and 42 percent had he been in the highest bracket.

The irrational relationship of prices of common stocks on today's market in relationship to earnings seems to be saying that investors believe the inflationary picture of the past will be continued and will be accelerated. If this be true, it is still more important that inflation should not be allowed to masquerade as capital gain, with a heavy tax penalty, when actually the so-called capital gain is a capital loss.

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